TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1928 29

No. ~~846~~ 67

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

AMERICAN CODE COMPANY, INCORPORATED

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 19, 1929
CERTIORARI GRANTED MAY 20, 1929

(34155)

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1928

No. ——

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

AMERICAN CODE COMPANY, INCORPORATED

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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1 Before United States Board of Tax Appeals

AMERICAN CODE COMPANY, INC., PETITIONER
vs.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
} Docket No. 9077

For taxpayer, Clark H. Hebner, Esq.
For commissioner, Bruce A. Low, Esq.

Docket entries

1925

Nov. 13 Petition received and filed.
" 19 Copy of petition served on solicitor.
" 19 Notification of receipt mailed taxpayer.
Dec. 10 Answer filed by solicitor.
" 12 Copy of answer served on taxpayer—assigned to general calendar.

1926

Nov. 24 Hearing date 2-3-27.

1927

Feb. 3 Hearing had before Mr. Phillips on merits—briefs due 5-3-27.
Feb. 7 Transcript of hearing of 2-3-27 filed.
Apr. 30 Brief filed by taxpayer.
" 30 Proposed findings of fact filed by taxpayer.

2

1928

Feb. 2 Findings of fact and opinion rendered—Mr. Phillips. Decision will be entered for the respondent.
" 28 Order of redetermination entered.
June 7 Petition for review by U. S. Cir. Ct. of Appeals, 2nd Cir., with assignment of errors, filed by taxpayer.
" 7 Proof of service filed by taxpayer.
" 7 Præcipe of record with proof or service filed by taxpayer.
July 27 Transcript of record sur petition for review sent U. S. Cir. Ct. of Appeals, 2nd Cir.

Now, July 25, 1928, the foregoing docket entries certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

3 **Before United States Board of Tax Appeals**

[Title omitted.]

Petition

The above-named taxpayer hereby appeals from the determination of the Commissioner of Internal Revenue set forth in his deficiency letter (IT:CA-2111-8-60-D) dated September 17, 1925 (the date of the mailing of which letter is unknown to the taxpayer), and as the basis of its appeal sets forth the following:

1. The taxpayer is a corporation duly incorporated under and by virtue of the laws of the State of New York, having its principal office and place of business at No. 206-208 Broadway, in the Borough of Manhattan, city, county, and State of New York.

2. The deficiency letter was dated September 17, 1925, the date of the mailing of the letter to the taxpayer being unknown.

3. The tax in controversy is income tax for the calendar year
4 1919, the amount of the deficiency tax proposed to be assessed being the sum of $122.91, the taxpayer, however, claiming to be entitled to a refund of $9,365.11, the original claim for refund in the sum of $10,036.79 having been reduced by reason of adjustments in items of the 1919 return made by the bureau and not contested by the taxpayer.

4. The determination of tax contained in such deficiency letter and the rejection of the taxpayer's claim for refund is based upon the following error:

In determining the taxpayer's net income for the year 1919 the Income Tax Unit has disallowed a deduction claimed by the taxpayer of a loss or liability which accrued in 1919, in the sum of $21,019.19, such sum representing the amount of a judgment rendered against the taxpayer in the Supreme Court of the State of New York in January, 1922, affirmed on appeal in 1923, and paid in 1923, but being the result of a suit for damages against the taxpayer begun in 1919 under a contract made and breached by the taxpayer in 1919, the disallowance of such deduction resulting in the rejection of the taxpayer's claim for refund and the proposed additional tax in the sum of $122.91.

5. The facts upon which the taxpayer relies as the basis of its appeal are as follows:

On the 3rd day of January, 1919, the taxpayer entered into a contract with one Cosmo Farquhar under and by virtue of which
5 the taxpayer agreed to employ said Farquhar as its sales manager for a term of years to end on February 1, 1937, Farquhar to be compensated for his services by the payment by the taxpayer of certain commissions based upon gross receipts from sales. The employment was entered into under the contract and continued until

May 1, 1919, when the taxpayer discharged said Farquhar and refused to continue him in its employ. In July, 1919, Farquhar brought suit against the taxpayer in the Supreme Court of New York County to recover damages for the taxpayer's breach of said contract of employment. The said suit was not reached for trial in its regular course upon the court calendar of said court until January 9, 1922. The trial was completed on January 10, 1922, and resulted in a verdict by the jury in favor of said Farquhar against the taxpayer in the sum of $21,019.19. The taxpayer appealed from said verdict to the appellate division of the supreme court, which appellate court affirmed the judgment. Further appeal was then taken by the taxpayer to the Court of Appeals of the State of New York, which court also in 1923 affirmed the said judgment, whereupon the taxpayer paid the same.

Meanwhile and on October 28, 1919, the taxpayer communicated with the Treasury Department, requesting that it issue a ruling allowing the taxpayer in making its income-tax return for 1919 to deduct the approximate amount of the taxpayer's liability on account of such breach of contract. On November 11, 1919, the Treasury Department, in a communication to the taxpayer, rules that
6 the deduction could not be claimed as a deduction from gross income in 1919. Nevertheless the taxpayer actually set up on its books as a liability for the year 1919, and for each subsequent year until actual payment was made, an amount to cover such liability. On January 21, 1925, the taxpayer prepared and filed with the Treasury Department a claim for refund on account of the 1919 taxes in the sum of $10,036.79, alleging that the income for that year had been reduced by $21,019.19, representing the judgment paid in 1923, but chargeable to income for 1919, the year in which the liability was actually incurred. Income and profits tax waiver for the year 1919 was duly executed and filed with the Treasury Department on or about November 26, 1924, extending until March 15, 1926, the time within which to determine a deficiency or other adjustment of tax.

6. The taxpayer in support of this appeal relies upon the following propositions of law:

(a) Section 234 of the revenue act of 1918 allows to a corporation as a deduction from gross income losses sustained during the taxable year not compensated for by insurance or otherwise.

(b) Regulation 45, article 111, allows a taxpayer making returns on an accrual basis to deduct all authorized allowances, whether paid in cash or set up as a liability.

(c) A taxpayer's liability for damage on account of his breach of contract is a damage and loss actually incurred at the date of the breach.

7 7. Annexed hereto is a copy of the letter of the Commissioner of Internal Revenue advising the taxpayer of determination of deficiency tax.

Wherefore the taxpayer respectfully prays that this board may herein determine its appeal.

(Signed) CLARK H. HEBNER,
Counsel for Taxpayer,
No. 50 Broad Street, Borough of Manhattan, New York City.

[*Duly sworn to by Cyrus F. Tibbals; jurat omitted in printing.*]

8 EXHIBIT TO PETITION

Address reply to Commissioner of Internal Revenue and refer to IT:CA–2111–8–60–D.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, Sept. 17, 1925.

AMERICAN CODE COMPANY,
206 Broadway, New York, New York.

SIRS: The determination of your income-tax liability for the years 1919 to 1921, inclusive, pursuant to an examination of your books of accounts and records, as set forth in office letter dated July 31, 1925, has been changed as a result of your letter of August 22, 1925, to disclose a deficiency in tax amounting to $122.91 for 1919 and an overassessment amounting to $45.74 for 1920, and no change for 1921, as shown in the attached statement.

In accordance with the provisions of section 274 of the revenue act of 1924 you are allowed 60 days from the date of mailing of
9 this letter within which to file an appeal to the United States Board of Tax Appeals contesting in whole or in part the correctness of this determination.

Where a taxpayer has been given an opportunity to appeal to the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement in respect of any part of the deficiency will be entertained.

If you acquiesce in this determination and do not desire to file an appeal, you are requested to sign the inclosed agreement consenting to the assessment of the deficiency and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT: CA–2111–8–60–D. In the event that you acquiesce in a part of the determination, the agreement should be executed with respect to the items agreed to.

Respectfully,

D. H. BLAIR, *Commissioner.*
By J. G. BRIGHT, *Deputy Commissioner.*

Inclosures: Statements; agreement, Form A.

10 STATEMENT

IT:CA-2111-8-60-D.

In re American Code Company, 206 Broadway, New York, New York.

DEFICIENCY IN TAX OVERASSESSMENT

1919	$122.91
1920	$45.74
1921	

1919—NET INCOME

Net income reported	$39,746.08
Add: Inventory adjustment in accordance with taxpayer's letter of August 22, 1925	267.20
Net income revised	40,013.28

INVESTED CAPITAL

Capital stock	$100,000.00	
Less: Treasury stock	38,800.00	
		$61,200.00
Paid-in surplus		14,375.00
Reserve		2,310.15
Total		77,885.15
11 Deduct: Intangibles as reported on return		51,911.68
Invested capital revised		25,973.47

TAX

Profits tax as limited under section 302	$11,405.31
Amount of 10% income tax	2,651.56
Total tax assessable	14,056.87
Tax previously assessed	13,933.96
Deficiency in tax	122.91

STATEMENT

In re American Code Company.

1920—NET INCOME

Net income in accordance with taxpayer's letter of August 22, 1925	$31,243.98

TAX

Profits tax as limited under section 302	$7,897.59
Amount of 10% income tax	2,085.14
Total tax assessable	9,982.73
Tax previously assessed	10,028.47
Overassessment	45.74

Your claim for refund of $10,036.79, income and profits tax for 1919, has been examined and will be rejected in full for the reason that the audit as shown in the above computation discloses a tax in addition to the amount previously assessed.

Your claim for refund of $861.12, income and profits tax for 1920, has been examined and will be allowed for $45.74 and rejected for $815.38, in accordance with the above computation.

Compilations are considered analogous to secret processes, formulæ, etc., inasmuch as the income derived therefrom is contingent on the preparation thereof.

It is also considered that the compilations and copyrights are intangible assets for the reason that their value is contingent upon and measured by their earning power. This is supported by your contention that prior to 1914 each individual owner earned a minimum of $10,000.00 per annum from the assets turned over to the corporation at the date of incorporation.

It is therefore held that the value of $200,000.00 placed on the book plates, compilations, and copyrights prior to the enactment of the excess profits tax be allowed for depreciation purposes only and that in computing invested capital the limitations for intangibles be applied.

The deduction of $21,019.19 claimed for 1919, representing the amount of a judgment rendered through a damage suit decided in 1923 and paid in 1923, which was based upon a contract entered into in 1919, cannot be allowed as a deduction in 1919. The decision referred to in your brief has not been acquiesced in by the commissioner.

The inventory adjustments have been allowed in accordance with your letter of August 22, 1925.

The right of appeal as indicated on page one of this letter refers only to any deficiency in tax indicated herein, inasmuch as there is no provision in the revenue act of 1924 granting the right of appeal against the determination of any overassessment found upon an audit of your returns.

Now, July 25, 1928, the foregoing petition certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

Before United States Board of Tax Appeals

[Title omitted.]

Answer

The Commissioner of Internal Revenue, by his attorney, A. W. Gregg, Solicitor of Internal Revenue, for answer to the petition of the above-named taxpayer, filed November 13, 1925, admits and denies as follows:

1. Admits the statements and allegations contained in the introductory paragraph and paragraphs numbered 1 and 2.

2. Admits that the tax in controversy is income tax for the calendar year 1921, in the sum of $122.91.

3. Admits all the material facts relevant to the issues herein involved alleged in paragraph 5 of taxpayer's petition except the following statement: "Nevertheless the taxpayer actually set up on his books as liability for 1919 and for each subsequent year until actual payment was made, an amount to cover such liability."

4. Denies that the damages for which the taxpayer became liable on account of the breach of contract with Cosmo Farquar, and for which reserves are alleged by the taxpayer to have been set up, were actually incurred in 1919.

5. Denies that the taxpayer set up on his books in 1919 a reserve in an amount approximately equal to a judgment rendered against it in 1923, or set up on its books reserves in 1919 in any sum.

6. Denies generally and specifically each and every allegation of taxpayer's petition not hereinbefore admitted, qualified, or denied.

PROPOSITION OF LAW

Only liabilities accruing at the time of the breach of contract which can be determined with approximate accuracy, and are so determined, as shown by evidence and are set up as liabilities for the year can be deducted from gross income of the year in question.

Wherefore it is prayed that the taxpayer's appeal be denied.

A. W. GREGG,
Solicitor of Internal Revenue,
Attorney for Commissioner of Internal Revenue.

Of counsel:
BRUCE A. LOW,
Special Attorney,
Bureau of Internal Revenue.

Now, July 25, 1928, the foregoing answer certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

16 Before United States Board of Tax Appeals

[Title omitted.]

Findings of fact and opinion

Feb. 2, 1928

The petitioner at the close of the taxable year set up on its books as a reserve for the breach of a contract of employment the amount which would have become due under such contract as commissions

had there been no breach. At that time the employee was suing for damages for the breach of such contract and the petitioner had denied any liability. The amount of the liability was not determined until a subsequent year. Held, that the petitioner was not entitled to deduct in the taxable year the amount so set up as a reserve.

Clark H. Hebner, Esq., for the petitioner.

Bruce A. Low, Esq., for the respondent.

The commissioner determined a deficiency of $122.91 in income and profits taxes of the petitioner for 1919. The petitioner seeks
17 a redetermination of such deficiency, alleging that it has made an overpayment of its taxes for such year in the amount of $9,365.11. The petition alleges that the commissioner committed error in refusing to allow the deduction of a loss alleged to have occurred in 1919 upon breach of a contract.

FINDINGS OF FACT

The petitioner is a New York corporation, organized in the year 1914 in the Borough of Manhattan of the city of New York.

On January 3, 1919, the petitioner entered into a contract of employment with one Cosmo Farquhar for a term to begin on January 3, 1919, and to end on February 1, 1937, the compensation of the employee to be a commission based upon the sales made in the petitioner's business.

On May 1, 1919, the petitioner discharged the said Cosmo Farquhar from its employ.

In July, 1919, Farquhar began action against the taxpayer in the Supreme Court of New York County to recover commissions due him for April, 1919, alleged to be $100, and for berach of the contract of employment, claiming damages for such breach in the amount of $100,000. The petitioner defended such action on the ground that Farquhar had previously breached his contract of employment and that his discharge was justified by reason of his failure to perform his duties. This action was reached for trial in January, 1922, and resulted in a verdict by the jury against the petitioner and an award of damages in favor of Farquhar for breach of contract in the sum of $21,019.19.

18 The petitioner appealed to the appellate division of the supreme court, State of New York, which court, on June 2, 1922, affirmed the judgment. Petitioner then appealed to the Court of Appeals of the State of New York, in which court the judgment was again affirmed on the 16th day of January, 1923.

The petitioner paid the amount of said judgment in January, 1923.

The petitioner kept its books and made its income-tax returns on the accrual basis.

The petitioner, at the close of the year 1919, set up on its books as a reserve for the breach of the contract of employment the amount of $14,764.79, such amount having been computed at the rates of

commission and on the basis specified in the said contract. At the close of the year 1920 this reserve was increased on the petitioner's books by $32,994.09 to conform to the amount of its liability computed on the same basis, and at the close of the year 1921, judgment having been rendered early in January, 1922, before the books had been closed for 1921, the reserves so set up on its books, amounting to $47,458.88, was adjusted to the liability as fixed by the judgment against the petitioner in the sum of $21,019.19.

On October 28, 1919, the petitioner wrote the commissioner that its employee was suing to recover commissions due under the contract and made a written request of the Commissioner of Internal Revenue for permission to deduct from petitioner's income-tax return for 1919 the accumulated commissions which would be due on
19 December 31, 1919, under the contract, which request was denied on November 11, 1919.

The petitioner, in compliance with said ruling by the commissioner, did not deduct in its 1919 income-tax return the amount set up as a reserve for 1919 commissions, but on January 21, 1925, its 1919 return being then in process of audit by the Income Tax Bureau, the petitioner filed a claim for refund with the Commissioner of Internal Revenue, in which it claimed the right to deduct from its income for the year 1919 the amount of its liability for breach of the said contract of employment, the sum of $21,019.19, and that by reason of such deduction it was entitled to a refund of income tax paid for 1919 in the sum of $9,364.85.

The commissioner, in a notice dated September 17, 1925, rejected such claim for refund and asserted a deficiency in tax against the petitioner for 1919 of $122.91.

OPINION

PHILLIPS: The decision of this case appears to be controlled by the decision of this board in Hidalgo Steel Co. v. Commissioner (8 B. T. A. 76).

Further, it should be noted that in the present case the amount set up on the books of the petitioner on account of its liability was the amount becoming due to Farquhar under the terms of the agreement. The suit, however, was not for commissions due under the contract (except as to the month of April, 1919) but was for breach of the contract. While the amounts becoming due under the contract
20 would be one element to be considered by the jury in fixing damages for its breach, it was by no means the measure of the damages sustained. It seems clear that the amounts set up on the books in 1919 and 1920 were not considered to be for damages for breach, but were intended to and did represent the amount which would have been a liability had the contract continued in force.

Decision will be entered for the respondent.

Now, July 25, 1928, the foregoing findings of fact and opinion certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

21 Before United States Board of Tax Appeals

[Title omitted.]

Order of redetermination

Pursuant to the board's findings of fact and opinion, promulgated February 2, 1928, it is

Ordered and decided that, upon redetermination, there is a deficiency for the year 1919 in the amount of $122.91.

(Signed) PERCY W. PHILLIPS,
Member, United States Board of Tax Appeals.

Enter: Washington, D. C., Feb. 28, 1928.

Now, July 25, 1928, the foregoing order of redetermination certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

22 In United States Circuit Court of Appeals for the Second Circuit

AMERICAN CODE COMPANY, INC., PETITIONER,
vs.
DAVID H. BLAIR, COMMISSIONER OF INTERNAL REVENUE, respondent
No. 9077. Term, 1928.

Petition for the review of decision of the United States Board of Tax Appeals

To the honorable, the judges of the United States Circuit Court of Appeals for the Second Circuit:

Your petitioner, American Code Company, Inc., respectfully represents that it is, and was at all the times hereinafter mentioned, a corporation duly incorporated under the laws of the State of New York, having its office at No. 206 Broadway, Borough of Manhattan, New York City.

In support of this, its petition filed in pursuance of the provisions of section 1001 of the act of Congress approved February 26th, 1926, entitled the "Revenue act of 1926," for the review of the decision of the United States Board of Tax Appeals rendered on the 2d
23 day of February, 1928, approving a deficiency in income tax of the petitioner for the calendar year 1919 in the amount of $122.91, your petitioner respectfully shows to this honorable court, as follows:

I. STATEMENT OF THE NATURE OF THE CONTROVERSY

1. That on November 13th, 1925, the petitioner filed with the United States Board of Tax Appeals, in pursuance of the provisions of the revenue act of 1924, its petition requesting a redetermination of a deficiency in income taxes for the calendar year 1919, amounting to $122.91, as shown by the final notice of deficiency mailed by the respondent under date of September 17th, 1925, and the allowance of a refund to the petitioner of $9,365.11.

2. That the said petition alleged that on January 3d, 1919, the petitioner entered into a contract of employment with one Cosmo Farquar for a term of years to end on February 1st, 1937, under which Farquar was to be compensated for his services by the payment to him of certain commissions based upon gross receipts from sales; that on May 1st, 1919, said Farquar was discharged by the petitioner, and in July, 1919, brought action in the Supreme Court of the State of New York, New York County, against the petitioner to recover damages for a breach of the said contract of employment; that said action was not reached for trial in its regular course until
24 January 9th, 1922; that said trial resulted in a verdict by the jury in favor of said Farquar against the petitioner in the sum of $21,019.19; that the petitioner appealed from said verdict to the appellate division of the Supreme Court of the State of New York, which court affirmed the judgment; that the petitioner then appealed to the Court of Appeals of the State of New York, which court in 1923 also affirmed the said judgment, which was thereupon paid by the petitioner; that in October, 1919, the petitioner requested a ruling from the respondent allowing it to deduct the approximate amount of its liability, on account of the alleged breach of contract, in its return for the year 1919, which ruling was refused; that your petitioner, nevertheless, actually set up on its books for the year 1919, and for each subsequent year until actual payment was made, a reserve or estimated amount of its loss to cover such liability; that the petitioner kept its books and made its income tax returns on the accrual basis; that on November 26th, 1924, the petitioner duly executed and filed with the respondent an income and profits tax waiver for the year 1919 extending until March 15th, 1926, the time within which to determine a deficiency or other adjustment of tax; that on January 21st, 1925, your petitioner prepared and filed with the respondent a claim for refund on account of 1919 taxes in the sum of $10,036.79, alleging that the income for that year had been reduced by $21,019.19, the amount of the judgment for breach of contract paid in 1923, but chargeable to income for 1919, the
25 year in which, by reason of the breach, the liability was actually incurred; that by reason of adjustment of items of the 1919 return made by the respondent and not contested by the petitioner the original claim for refund was reduced to the sum of $9,365.11; that by the letter of determination dated September 17th, 1925, the respondent disallowed the petitioner's claim for refund

and claimed a deficiency in tax in the sum of $122.91, as hereinafter set forth.

3. That thereafter and on December 10th, 1925, respondent filed with the said board its answer to the said petition, which answer admitted that the petitioner was a corporation organized and existing under the laws of the State of New York, having its principal place of business at No. 206 Broadway, Borough of Manhattan, city of New York; that the respondent had mailed to the petitioner a notice of deficiency in the sum of $122.91 for the calendar year 1919; that all the material facts alleged in the petition were true except the statement that the taxpayer actually set up on its books as a liability for 1919 and for each subsequent year until actual payment was made an amount to cover such liability; but which answer denied that the damages for which the petitioner became liable and for which reserves were set up by the petitioner were actually incurred in 1919.

4. That the cause, being at issue under the rules and practice of said board upon the filing of such answer, duly came on for hearing
on February 3rd, 1927, at which time the petitioner by compe-
26 tent witnesses submitted testimony in support of the allega-
tions as aforesaid. Thereafter, on February 2nd, 1928, said board rendered its findings of fact, which were in substantial accordance with the facts as alleged in the petition, and as hereinbefore set forth, together with an opinion in which it was held (by reference therein to the previous decision of said board in Hidalgo Steel Company v. Commissioner, 8 B. T. A. 76) that the damages for the said breach of contract were not incurred in 1919, the year of the breach, and that decision should be entered for the respondent. On February 28th, 1928, the said board entered its final order of redetermination, approving the deficiency as determined by the respondent, in the amount of $122.91.

II. DESIGNATION OF COURT OF REVIEW

1. The petitioner, being aggrieved by the said opinion, decision, and order, and being a corporation with its principal place of business in the Borough of Manhattan, city of New York, desires a review thereof in accordance with the provisions of the revenue act of 1926 by the United States Circuit Court of Appeals for the Second Circuit, within which circuit is located the office of the collector of internal revenue to whom the petitioner made its income-tax returns.

III. ASSIGNMENT OF ERRORS

The petitioner, as a basis for review, makes the following assign-
ments of error:
27 1. The opinion of the Board of Tax Appeals is in error in
holding that the amount set up on the books of the petitioner for the years 1919 and 1920 were not considered to be for damages

for breach of contract, and such holding is not in accordance with but is contrary to the findings of fact made by said board.

2. The Board of Tax Appeals erred in holding (by reference to its previous decision in Hidalgo Steel Company v. Commissioner, 8 B. T. A. 76) that damages for breach of contract, not finally determined until a future year, are an allowable deduction in the year of the breach only in those cases in which admission of the liability is made during the year of the breach.

3. The Board of Tax Appeals erred in holding (by reference to its previous decision in Hidalgo Steel Company v. Commissioner, 8 B. T. A. 76) that denial by a taxpayer of liability for breach of contract by contesting such breach before the courts changes the date as of which the liability is incurred from the date of the breach to the date of payment of the damages as finally determined.

4. The Board of Tax Appeals erred in holding that the petitioner is not entitled to deduct from its 1919 income the damages sustained by it by reason of the breach of contract which occurred in that year.

5. The board erred in rendering decision for the respondent.

28 Wherefore your petitioner prays that this honorable court may review said decision, opinion, and order and reverse and set aside the same, and that the clerk of the United States Board of Tax Appeals be directed to transfer and deliver to the clerk of said court certified copies of all and every of the documents necessary and material to the presentation and consideration of the foregoing petition for review and as required by the rules of said court and statutes made and provided.

And your petitioner will ever pray.

AMERICAN CODE COMPANY, INC.,
By CYRUS F. TIBBALS, Jr.,
Vice President.

CLARK H. HEBNER,
Attorney for the Petitioner,
No. 21 East 40th Street, Manhattan, New York.

29 [*Duly sworn to by Cyrus F. Tibbals, jr.; jurat omitted in printing.*]

Now, July 25, 1928, the foregoing petition for review certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

30 Before United States Board of Tax Appeals

[Title omitted.]

Præcipe

To the CLERK OF THE UNITED STATES BOARD OF TAX APPEALS.

You will please prepare and, within sixty days from the date of the filing of the petition for review in the above stated case, transmit to the clerk of the United States Circuit Court of Appeals for the Second Circuit certified copies of the following documents:

1. The docket entries of proceedings before the United States Board of Tax Appeals in the case above entitled.
2. Pleadings before the board.
3. Findings of fact, opinion, and decision of the board.
4. Petition for review.

31 The foregoing to be prepared, certified, and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Second Circuit.

(Signed) CLARK H. HEBNER,
Attorney for American Code Company, Inc.

JUNE 7TH, 1928.

Now, July 25, 1928, the foregoing præcipe certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

(2412)

32 In United States Circuit Court of Appeals for the Second Circuit

No. 109, October term, 1928. Argued December 12, 1928. Decided January 14, 1929

AMERICAN CODE COMPANY, INC., PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

APPEAL from the United States Board of Tax Appeals.
Before MANTON, SWAN, and AUGUSTUS N. HAND, Circuit Judges.

Opinion

The Commissioner of Internal Revenue having determined a deficiency in income and profits taxes for the year 1919, and his action having been confirmed by order of the Board of Tax Appeals, the taxpayer has appealed to this court. Reversed.

The taxpayer is a New York corporation. In May, 1919, it discharged its general sales manager, who had been employed under a long-term contract which provided as compensation for a commission on the corporation's sales and was not to expire until 1937. In July, 1919, the employee brought suit, and in January, 1922, obtained a judgment, on verdict of a jury, for $21,019.19. An appeal by the corporation utimately resulted in affirmance by the court of last resort (Farquhar v. American Code Co., 234 N. Y. 650, 138 N. E. 483) in January, 1923. The judgment was then paid.

The corporation kept its books and made its income-tax returns on the accrual basis. Although contesting the employee's suit and denying that his discharge was wrongful, it set up on its books for the year 1919, as a reserve for liability for breach of the contract, the sum of $14,764.79, such amount being computed upon the basis of the commissions which the employee would have earned during the year had he not been discharged. At the close of the year 1920 this reserve was increased in an amount similarly computed. Before the books were closed for the year 1921, the judgment was rendered, and the reserve account was then adjusted to conform to the amount of the judgment. In the taxpayer's return for 1919 no deduction of the aforesaid reserve for that year was made, because the commissioner had ruled that it would not be permitted; but in January, 1925, its 1919 return being then in process of audit by the Income Tax Bureau, the taxpayer filed a claim for refund, asserting the right to deduct from its gross income for 1919 the amount of its liability for breach of the contract as established by the judgment, and claiming that such deduction entitled it to a refund of $9,364.85. The commissioner disallowed the claim and determined a deficiency in tax of $122.91. His action was confirmed by the Board of Tax Appeals, whose opinion is reported in 10 B. T. A. 476.

Clark H. Hebner, of New York City, for appellant.

Mabel Walker Willebrandt, Asst. Atty. Gen. (Sewall Key and John Vaughan Groner, Sp. Asst. Attys. Gen., and C. M. Charest, Gen. Counsel, Bureau of Internal Revenue, of Washington, D. C. of counsel), for respondent.

SWAN, Circuit Judge (after stating the facts as above): The correctness of the action of the commissioner depends upon the construction of the revenue act of 1918. Section 234 (a) of that act
33 (40 Stat. 1077) permits a corporation to deduct from its gross income:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *

"(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise. * * *"

The act also permits taxpayers to file returns on the accrual basis if their books are so kept. Section 232 (40 Stat. 1077) directs that the net income of corporations shall be computed on the same basis

as is provided in subdivision (b) of section 212. That subdivision (40 Stat. 1064) provides:

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the commissioner does clearly reflect the income. * * *"

Under the authority of section 1309 (40 Stat. 1143), the commissioner, with the approval of the Secretary of the Treasury, promulgated regulations for the enforcement of the provisions of the act. Article 111 of Regulations (1920 ed.) reads in part as follows:

"ART. 111. WHEN CHARGES DEDUCTIBLE.— * * * The expenses, liabilities or deficit of one year can not be used to reduce the income of a subsequent year. A person making returns on an accrual basis has the right to deduct all authorized allowances whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes, or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities. A loss from theft or embezzlement occurring in one year and discovered in another is deductible only for the year of its occurrence. Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement, or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. See section 252 of the statute and articles 1031–1038."

The problem presented is whether the foregoing provisions of the statute and the regulations permit a taxpayer, who has committed a breach of contract in 1919, and sets up on its books a reserve for such liability, and files a return on the accrual basis, to deduct from its gross income for such year the amount of its liability as established by judgment rendered in a subsequent year.

If the judgment had been rendered early in 1920 and prior to the time when the taxpayer was required to file its 1919 return, it would seem clear that the liability should be considered as a business expense incurred, or a loss sustained, during the year when the contract was broken. Although the amount of the damages was deter-

mined later, all the facts which gave rise to the liability occurred in 1919. It is settled contract law that damages are suffered when the contract is broken, and are assessed as of that time, their amount being the value of the contract to the plaintiff at the time of the breach. (Parker v. Russell, 133 Mass. 74, 75; Pierce v. Tenn. Coal Co., 173 U. S. 1, 16, 19 S. Ct. 335, 43 L. Ed. 591.) Under the regulation above quoted, a taxpayer making returns on the accrual basis is required to deduct all authorized allowances "whether paid in cash or set up as a liability," and provision is made in the final sentence of article 111 for corrections by amended returns when the amount of the loss is ascertained subsequent to the year of its occurrence.

In Appeal of Producers' Fuel Co. (1 B. T. A. 202), it was held that a taxpayer's liability for damages on account of a breach of contract in 1920 was a loss sustained and deductible in that year, although the amount of the damages, determined by negotiation, was agreed upon and paid during the following year. The reserves which the taxpayer had set up on its books and deducted in
34 its return for 1920 were slightly too large, and the board substituted for the orginal estimates the amount of loss as ultimately determined by payment. Subsequently, however, the Board of Tax Appeals limited the foregoing decision to cases in which the taxpayer admits its liability, as by offer of settlement, immediately after the breach of contract. (Hidalgo Steel Co. v. Commissioner, 8 B. T. A. 76.)

This ruling was followed in the case at bar. The basis for the distinction is not apparent to us. The legal liability is the same, whether the suit is defended or not. It is not the admission, but the breach of contract, which creates the liability. The admission of liability by offering a settlement which merely becomes the basis of negotiation between the parties concededly does not determine the amount of the deduction. This was held in Appeal of Producers' Fuel Co., supra. The taxpayer must, it is true, admit to itself the probability of liability by setting up a reserve upon its boks to provide for it, but we find nothing in the revenue act of 1918 which makes an admission to the creditor a material fact in determining whether the reserve is an authorized deduction.

While the amount of the appellant's liability was not ascertained until a future year, we think that the loss was sustained when the contract was broken and must be considered before the income of that year can be determined. When books are kept on an accrual basis, estimated reserves for unliquidated liabilities must necessarily be used. This was recognized in United States v. Anderson (269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347). There it was held that a taxpayer, who filed on an accrual basis, must deduct from 1916 gross income the tax imposed on munition manufacturers for that year, although the tax was not assessed and paid until 1917. In referring to Treasury Decision 2433, which is analogous to article 111 of Regulations 45, Mr. Justice Stone, at page 438 of 269 U. S. (46 S. Ct. 133), says:

"It also provided in substance that when the taxpayer, following a consistent accounting practice, sets up reserves to meet liabilities, the 'amount of which or date of maturity' is not definitely determinable, such reserve may be deducted from gross income. The decision also laid down a procedure for readjusting such reserves when the amount actually required for that purpose was definitely ascertained, and provided that if returns upon this basis of 'accrual or reserves' did not reflect true net income, the taxpayer would not be permitted to make its return on any other basis than that of 'actual receipts and disbursements.'"

We think the principle of the Anderson decision covers liability for breach of contract no less than liability for unassessed taxes. In either case all the facts which create the liability have occurred before the end of the year; in the one, the liability is to be liquidated by a jury; in the other, by the Commissioner of Internal Revenue. In the case of taxes the possibility of setting up a reserve accurately measuring the liability may be greater than in the case of breach of contract. But the difficulty of forecasting the damages which the jury may award is not present in the instant case, for judgment had already been rendered when the commissioner was asked to allow the deduction.

We find nothing in Lewellyn v. Electric Reduction Co. (275 U. S. 243, 48 S. Ct. 63, 72 L. Ed. 262), which is inconsistent with considering appellant's contract liability as a loss sustained in 1919. The question there was whether an asset (a contract right to receive goods paid for in advance), which was believed to be good and was carried on the books as a receivable, should be treated as a loss in the year when the asset was ascertained to be worthless, or in the year when it was created by prepayment for the goods. Whether the taxpayer kept his books on a cash or an accrual basis does not appear, but he did not charge off the asset in the year in question. In the instant case we are not dealing with an asset believed to be good, but subsequently found worthless, but with a liability for which a reserve was set up on the books in the year when the contract was broken.

For the reasons given, we hold that the loss was sutained during the year 1919, and should be allowed as a deduction from gross income for that year. It does not appear to be disputed that if the deduction is made the taxpayer will be entitled to a refund in the sum of $9,364.85. The order of redetermination of deficiency is reversed and the cause remanded to the Board of Tax Appeals for entry of an order in conformity with this opinion.

35 In United States Circuit Court of Appeals, Second Circuit

AMERICAN CODE COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

APPEAL from the United States Board of Tax Appeals.

Decree

Filed Jan. 21, 1929

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals and was argued by counsel.

On consideration whereof it is now hereby ordered, adjudged, and decreed that the order of said board be, and it hereby is, reversed and cause remanded with instructions to enter an order in conformity with the opinion of this court.

It is further ordered that a mandate issue to the said board in accordance with this decree.

M. T. M.
T. W. S.

36 [File endorsement omitted.]

37 [Clerk's certificate to foregoing transcript omitted in printing.]

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Supreme Court of the United States

Order allowing certiorari

Filed May 20, 1929

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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